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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1933.

No. 212

WILLIAM R. THORSEN,

Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Respondent.

CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF IN BEHALF OF PETITIONER, WILLIAM R. THORSEN.

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SUMMARY OF ARGUMENT:

1.

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2.

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I.

Official Reports of the Opinions Delivered Below.

The opinion of the Circuit Court of Appeals for the Ninth Circuit in this case is found in 65 Fed. (2d) 234. The Findings of Fact, Opinion and De-

cision of the Board of Tax Appeals, (Trans., 54-65) are reported in 24 B. T. A. 480. The opinion of the Circuit Court of Appeals for the Seventh Circuit in the companion case of *Canfield* v. *Commissioner* is reported in 62 Fed. (2d) 751.

II.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on May 19, 1933. (Trans., 93.) The petition for a writ of certiorari was filed on June 29, 1933, and was granted on October 9, 1933. The jurisdiction of this court rests on Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

III.

Statement of the Case.

The Commissioner of Internal Revenue on March 6, 1928, found a deficiency of $36,720.96 in the income tax for the calendar year 1923 of William R. Thorsen, a resident of San Francisco, California. On November 25, 1927, he had likewise found a deficiency of $9,243.66 in the income tax for the same year of Charles J. Canfield, a resident of Chicago, Illinois. Each taxpayer thereafter filed his petition in the United States Board of Tax Appeals for a review of the finding in his case. These appeals were there consolidated for hearing and the Board, by a vote of 8 to 7, in a single opinion, sustained the findings of the Commissioner. A dissenting opinion was also filed. The Board recomputed the deficiency under its Rule 50 and found the amount to be $27,131.69.

Both Thorsen and Canfield were stockholders in West Side Lumber Company, a California corporation, and the additional tax in each case was a surtax assessed solely on account of the receipt by each of his share of a dividend paid by that company on April 14, 1923.

After the decision by the Board, Canfield perfected his appeal to the United States Circuit Court of Appeals for the Seventh Circuit, and that court on January 13, 1933, *reversed* the decision of the Board so far as it affected him.* Meanwhile, Thorsen perfected his appeal to the United States Circuit Court of Appeals for the Ninth Circuit, which on May 19, 1933, upon identical facts and upon the same issues of law, *affirmed* the decision of the Board of Tax Appeals so far as it affected Thorsen. The Commissioner then filed his petition here for certiorari in the Canfield case and Thorsen filed a similar petition in his case. This Court on October 9, 1933, granted both petitions.

All the facts were stipulated and are substantially

* The Board of Tax Appeals, in *Walker* v. *Commissioner*, 27 B. T. A. 829, in an opinion therein stated to have been prepared before (but which was announced after) the Canfield decision in the Circuit Court of Appeals for the Seventh Circuit, squarely reversed its previous position and adopted the views asserted by Canfield and Thorsen. After the decision of the Circuit Court of Appeals of the Ninth Circuit in the Thorsen case, the Board refused to reconsider the Walker case, although Walker is a resident of the Ninth Circuit. It adhered to its decision in the Walker case in *Bouton; Garrett et al.* v. *Commissioner*, Mem. Op. March 10, 1933. Thus, the present view of the Board, the view of the Circuit Court of Appeals for the Second Circuit in *Hadden* v. *Commissioner*, 49 Fed. (2d) 709, and that of the Circuit Court of Appeals for the Seventh Circuit, all accept the theory of Thorsen. The only opposing decision is the one of the Ninth Circuit here under review. In the *Hadden* case, the Court said:

> "The accumulated profits since March 1, 1913, must necessarily mean the net excess of all profits between March 1, 1913, and the date of distribution, less all losses sustained between the same dates."

While the Commissioner calls this statement dictum, a full understanding of the *Hadden* case shows that the company there involved had an actual surplus on March 1, 1913, and hence that the above statement was decision and not dictum.

identical in the two cases. The facts in this case will be found at pages 38 to 49 of the Transcript. From these it appears that:

During the period from March 1, 1913, to and including April 14, 1923, the capital stock of West Side Lumber Company, a California corporation, of San Francisco, California, consisted of 15,000 shares of the par value of $100 each. Thorsen owned 3,270 and Canfield 600 of such shares during all of such period. On March 1, 1913, West Side Lumber Company had its original capital of $1,500,000 and also a surplus of $4,332,684.78. On April 14, 1923, its surplus was $5,093,120.71, or an increase of $760,435.93 over the surplus of March 1, 1913.

The profits and losses of the company after March 1, 1913, were as follows:

Year Ending	Profits	Losses
February 28, 1914...	$ 4,594.62	
February 28, 1915...		$193,139.67
February 29, 1916...		211,707.32
February 28, 1917...	60,495.56	
February 28, 1918...	57,901.55	
February 28, 1919...	208,737.34	
February 29, 1920...	543,490.33	
February 28, 1921...	640,837.43	
February 28, 1922...	182,954.63	
February 28, 1923...	718,858.29	
March 1, 1923 to April 14, 1923 (44/366 of $311,209.54)	37,413.17	
	$2,455,282.92	$404,846.99

The difference between the above totals is $2,050,435.93. During the years 1918 to April 1923, West Side Lumber Company had distributed $1,290,000 of

this amount in dividends. (Trans., 45.) The remaining undistributed net balance arising out of March 1, 1913, to April 14, 1923, operations was, therefore, as of April 14, 1923, $760,435.93.

On that date, the Company paid a dividend of $5,100,000, of which Thorsen received $1,111,800 on his 3,270 shares. The difference between the parties is as to what part of this $5,100,000 was "accumulated" by West Side Lumber Company "since February 28, 1913," and therefore taxable to the recipient by the provisions of Section 201 (a) of the Internal Revenue Act of 1921. The taxpayer asserts that the above net of operations of that period, or $760,435.93 (being 14.91 per cent of the dividend) constituted such accumulations.* The Commissioner, however, insists upon the sum of $1,160,658.30 (being 22.75 per cent of the dividend) as the sum thus accumulated. He arrives at this figure by omitting entirely from his computation the operations of the Company from March 1, 1913, to February 29, 1916. The exact issue is as to whether he may properly do this.

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*Thorsen originally returned 16.35 per cent of the dividend received by him, or $181,812, as taxable. This difference between 16.35 per cent and the later and correct figure of 14.91 per cent was due to certain errors in the original income tax return of West Side Lumber Company, which were later corrected by the Commissioner. Thorsen in making his return followed the figures in the Company return. Therefore, if the percentage of 14.91 be correct, he is entitled herein to a refund, as he should have reported $165,769.38 instead of $181,812 as taxable. (He also reported a dividend of $32,700 received by him on February 12, 1923, about which no question is raised). Because the recomputations of the Commissioner in his review of the return of West Side Lumber Company lowered its net income, $6,879.29 of the dividend of April 14, 1923, made before that review, was in fact paid out of paid-in capital. The Commissioner's figures (Trans., 43-45) contain three small arithmetical mistakes ($4,337,289.40 instead of $4,337,279.40; $208,707.34 for $208,737.34; and $37,418.17 for $37,413.17) which give an incorrect total of $2,450,658.30 instead of $2,450,688.30, the correct total. These matters account for the discrepancy between the Commissioner's figures $3,932,442.41 and $3,939,341.70 on pages 43 and 45 of the Transcript.

The case is governed by Section 201 of the Act of 1921 which reads as follows:

"(a) That *the term 'dividend'* when used in this title (except in paragraph (10) of subdivision (a) of Section 234 and paragraph (4) of subdivision (a) of Section 245) *means any distribution made by a corporation* to its shareholders or members, whether in cash or in other property, *out of its earnings or profits accumulated since February 28, 1913,* except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922.

(b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits to the extent of such earnings or profits accumulated since February 28, 1913; but *any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.* If any such tax-free distribution has been made, the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that the basis provided in Section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon." (Italics supplied by us.)

IV.

Specification of Errors Intended to Be Urged.

The petitioner intends to urge all the errors that are specified on page 11 of the petition for certiorari filed by him, namely:

1. The Circuit Court of Appeals of the Ninth Circuit erred in finding that any deficiency existed with respect to the income taxes of Thorsen for the calendar year 1923.

2. It erred in not finding that Thorsen is entitled to a refund of income taxes overpaid by him for the calendar year 1923.

3. It erred in so interpreting the provisions of Section 201 of the Internal Revenue Act of 1921 that the losses of West Side Lumber Company for the years ending February 28, 1915, and February 29, 1916, were not deducted from its total profits of the years March 1, 1916, to April 23, 1923, in computing its "earnings accumulated since February 28, 1913," within the meaning of such section.

4. It erred in not finding that the words "earnings or profits accumulated since February 28, 1913," in Section 201 of the Internal Revenue Act of 1921 mean the net profits of the whole period from March 1, 1913, to the date of the distribution of profits.

5. It erred in finding that the dividend distribution of West Side Lumber Company on April 14, 1923, was 22.75 per cent taxable instead of 14.91 per cent taxable.

V.

Summary of Argument.

1. The Revenue Act of 1921 (Section 201) provides that dividends "accumulated since February 28, 1913," only are taxable. To ascertain what is accumulated by a corporation, one must take the time after February 28, 1913, to the day of the date of the dividend, as one single period (entire and undivided); and the amount accumulated (and hence taxable) is the difference between the total income and the total outgo for the period. Likewise, the time before March 1, 1913, must be taken as a single period; and the amount accumulated prior to that date may be distributed tax-free after the amount accumulated since that date has been distributed. The amount accumulated prior to March 1, 1913, must be the surplus as of that date—a fixed and definite amount which, for income tax purposes, may not be increased or diminished by the operations of subsequent years.

2. If the Act is thus properly interpreted, it must necessarily follow that the surplus of a corporation for the purposes of levying taxes under the act should be treated precisely the same as capital.

3. The Circuit Court of Appeals of the Seventh Circuit rightly interpreted the act and applied it to the facts. The Circuit Court of Appeals of the Ninth Circuit at the threshold of its consideration of the case, erroneously made and stressed the point that a question of exemption from tax was involved; whereas the real question is what is, rather than what is not, to be taxed. In arriving at an interpretation of the section in question, it did not give due consider-

ation to the first paragraph of Section 201, which provides that dividends from earnings or profits accumulated since February 28, 1913, only, are taxable. Likewise its judgment was colored by an erroneous view of the bookkeeping aspects of the case, and it improperly gave consideration to the course of interpretation of the statute by the Treasury Department itself. Thus finally it came to an unsound conclusion directly in conflict with that of the Circuit Court of Appeals for the Seventh Circuit.

VI.

Argument.

1.

THE TAXABLE PORTION OF THE DIVIDEND IS THE DIFFERENCE BETWEEN THE TOTAL INCOME AND THE TOTAL OUTGO FOR THE ENTIRE PERIOD FROM FEBRUARY 28, 1913, TO THE DATE OF THE DIVIDEND.

The real question in this case is the application of paragraph (a) of Section 201 of the Revenue Act of 1921 to the stipulated facts. The Commissioner is seeking to tax a dividend received by the taxpayer. Admittedly a part of the dividend is taxable—that part which consisted of the earnings or profits of the corporation "accumulated since February 28, 1913."

The Commissioner asserts that 22.75 per cent and the taxpayer answers that 14.91 per cent of the dividend is taxable. Each claims that the stated percentage measures the amount of the dividend accumulated since February 28, 1913; and both admit that the portion of the dividend representing accumulations "prior to March 1, 1913," is free from tax.

The inquiry, therefore, is to find what part was "accumulated since February 28, 1913." This is taxable. The balance is not taxed.

Hence, the point in controversy is the meaning of the words "accumulated since February 28, 1913." Do these words mean the difference between the aggregate of profits and the aggregate of losses, that is to say, the net increase in assets for the period? If they do, the taxpayer is right. Or, do they mean that under the facts here presented, the operations for the year ending February 28, 1914, and the losses for the years ending February 28, 1915, and February 29, 1916, shall be disregarded in computing the amount "accumulated since February 28, 1913" and that the amount so arrived at shall be deemed to be the aggregate of the profits from the year beginning March 1, 1913, to the date of the payment of the dividend? If they do, the Commissioner is right.

Thus we have simply a question of the interpretation of a section of a tax law. This Court has held that tax laws are not to be interpreted so as "to extend their provisions, by implication, beyond the clear import of the language used or to enlarge their operations so as to embrace matters not specifically pointed out." "In case of doubt they are construed most strongly against the Government, and in favor of the citizen."* A tax law, therefore, must point out what is to be taxed, in clear and unmistakable terms.

Section 213 of the Revenue Act of 1921 provided that "dividends" shall be taxed. There were in that section no words of definition. That function is per-

Gould v. *Gould*, 245 U. S. 151; 62 L. Ed. 211; 38 S. Ct. 53. *Burnet* v. *Niagara Falls Brewing Company*, 282 U. S. 648; 75 L. Ed. 594; 51 S. Ct. 262.

formed by Section 201 (a). This section (here to be interpreted) defined and limited the words "dividends" to "any distribution made by a corporation to its shareholders * * * out of its earnings or profits accumulated since February 28, 1913" (etc.). Thus, obviously, the only dividend that is taxed at all by the act is one (a) that is out of earnings or profits (b) that have been "accumulated" since February 28, 1913.

The opinion below in the Thorsen case erroneously says (Trans., 89):

> "We are here concerned with the extent of the exemption conferred by the Act of 1921."

This fundamental error greatly influenced the whole of the opinion and the decision of the court. Section 201 (a) creates no exemption.* There is no negation or exception in its terms or meaning. It is wholly affirmative and definitive. It specifies the sole and only kind of dividend that *is* taxed, namely, one from earnings and profits accumulated after February 28, 1913. All others are simply not taxed.

The chief reason advanced by the Commissioner and the court below for stressing the point that a question of exemption is involved in this case, seems to lie in the fact that Congress had taxed all dividends, (other than those distributing paid-in capital) by a prior Act—that of 1913. But clearly Congress either had changed its mind or had not expressed in that act its real purpose—*i. e.*, to draw a sharp line, on March 1, 1913, between the accumulations of the

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* It is in marked contrast with the treatment accorded real exemptions under Section 213, (b), which, after a definition of "gross income" under 213 (a), reads: "Does not include the following items, *which shall be exempt from taxation under this title.*" Then follow twelve paragraphs enumerating such exemptions.

period before the Sixteenth Amendment and the accumulations of the period thereafter, for, before the final interpretation of the 1913 Act by this court, it forthwith in 1916 changed the rule of the 1913 Act.

The term "dividends" in the 1913 Act meant all dividends irrespective of the period of accumulation, and, hence, included two things, (1) a payment from accumulations before March 1, 1913, and (2) a payment from accumulations after that date. The 1916 Act defined the term as meaning only one of these two. It cannot properly be said that this was exempting the former thing from the rule applying only to the latter. They were co-equal situations and the new act simply imposed a tax on one class and not on the other. It is as if dividends were a genus with two distinct separate species, and Congress decreed that only one species should be taxed.

The prior state of the law is unimportant excepting as a background. The 1913 Act was not amended by the 1916 or 1921 Acts. Both were entirely new Acts. The 1913 Act ceased to be a taxing act for later distributions with the advent of the Act of 1916. The new act selected one thing to be taxed, and one only, and named it. Whether Congress was rectifying a mistake or had changed its mind in eliminating for the future the rule yet-to-be-announced (nearly two years later) of *Lynch* v. *Hornby**, it was not creating an exception to a rule;—it was making a *new* rule to change the subject of taxation and to remedy the situation created by the Commissioner in claiming that all dividends were taxable under the 1913 Act. Thus, we are entitled to that liberality of construction which always accompanies a remedial statute, instead of being catalogued as the recipient of an ex-

*247 U. S. 339; 62 L. Ed. 1149; 38 S. Ct. 543.

emption from a tax which had ceased to be with the end of the 1913 Act.

The word "exempt" found in paragraph (b) is unimportant—particularly in interpreting paragraph (a). Paragraph (b) is not the taxing part of the act. Paragraph (a) fixes the tax. Paragraph (b) is a supplemental and subordinate part of the section. The history of this paragraph demonstrates that the provisions therein chiefly relied upon by the Commissioner were enacted solely with reference to differences in rates as between the several years after March 1, 1913. It has performed no function whatever in fixing the taxable and non-taxable parts of a distribution as between the years before and the years after March 1, 1913. It concerns these periods only in two respects: (1) it reiterates, out of caution, merely, the inviolability of earnings accumulated prior to March 1, 1913, and (2) requires the taxable accumulations of the *post*-1913 period to be distributed ahead of the tax-free accumulations of the *ante*-1913 era. The word "exempt" is there used wholly in the sense of *tax-free*. The only part of Section 201 that imposes, or limits or defines any tax is paragraph (a), which appeared first in the 1916 Act. To it alone we must look to find the incidence and character of the tax. Paragraph (b) was not in the 1916 Act. It appeared first in the 1917 Act when it was inserted primarily to meet the situation arising because of the war rates imposed by that act.

These matters would not be of importance were it not for the claim of the Commissioner, and the apparent view of the Circuit Court of Appeals of the Ninth Circuit, that somehow some variety or other of burden is thrown upon the taxpayer, rather than upon the Commissioner, in approaching the inter-

pretation of Section 201 (a). As we conceive it, the proper interpretation of a statute is not a matter involving either presumptions or burdens. It is a search for the intent of the lawmakers. We are not here concerned with any question of fact, but only with the legal meaning of certain words, and the court approaches this task without presumptions of any kind. No tax can be levied without specific legislative authority therefor. The extent of the power of the taxing body is only that fixed by the statute. In that sense, therefore, there is a burden upon the Commissioner to demonstrate that the language employed by Congress justifies the tax here asserted by him. The only power to tax a dividend given to him by the act is that of taxing a specific variety of dividend, one declared out of earnings or profits *"accumulated since February 28, 1913."* No other dividend distribution is taxed. He must therefore demonstrate that the portion of the dividend of April 14, 1923, which he seeks to tax was "accumulated since February 28, 1913," within the meaning of Section 201 (a).

March 1, 1913, is an epochal date in Federal income tax legislation. The Sixteenth Amendment became a part of the Constitution on February 25, 1913. The income tax act of 1913 was enacted on October 3, 1913, and was made expressly retroactive to March 1, 1913. This date, rather than February 25, 1913, was chosen by Congress purely for convenience, but in substance it marks the time when Congress could constitutionally lay a non-apportioned income tax. It is therefore a definite point of departure and whenever used, is deeply significant.

This date is made the dividing point in Section 201 (a) of the 1921 Act. The plan of Congress in this respect would seem to be self-evident, namely, to create two wholly independent *periods,* the first embracing all time antedating income taxation (the income of which is *not* taxed) and the second embracing all time beginning with income taxation down to the date of any given dividend payment,* (the income of which *is* taxed on distribution). This conception of *two entire periods* is fundamental in interpreting this section. The period, as such, is obviously the unit for determining "earnings and profits accumulated *prior* to March 1, 1913." In exactly the same way, the *period* beginning March 1, 1913, and ending April 14, 1923, *as such,* and not the separate component years thereof, is the unit for determining the earnings and profits "accumulated *since* February 28, 1913."

The earnings and profits accumulated in any given *period* are necessarily the net of *all* operations during the period. The Commissioner, however, in this case in attempting to compute the amount "accumulated" by West Side Lumber Company "since February 28, 1913," entirely excludes from the reckoning all the operations of that company from February 28, 1913, to March 1, 1916. He has taken the *several years of the period* as separate units of accumulation, and excludes the first three for reasons which he deems sufficient. The taxpayer's mode of computation, to the contrary, adopts the whole period, as a period, as the unit and excludes from the reckoning none of the company operations between February 28, 1913, and April 14, 1923. If Congress

*In *Lucas* v. *Alexander*, 279 U. S. 573, 73 L. Ed. 851, 49 S. Ct. 426, this Court spoke of the two "periods before and after March 1, 1913."

intended accumulations to be computed by the period, our result is necessarily correct.

The Statute splits the two periods of accumulation on the date of March 1, 1913. The Commissioner by his mode of computation does not do this. He has in effect, *three* periods, (1) that prior to March 1, 1913, (2) then a net loss period from March 1, 1913, to February 29, 1916, and (3) a final "accumulation" period from March 1, 1916, to April 14, 1923. (Trans., 43-45.) His first period accepts the admitted surplus of March 1, 1913, of $4,332,684.78. His second period shows a net operating loss over three years, which results in a surplus of $3,932,442.41 as of February 29, 1916. This figure never again appears in his computations and therefore might just as well never have been arrived at. It is merely laid on the shelf. It does not in any way connect up with any figures used in the third period.

His real computation is that of the third period. It starts with the caption, "*Subsequent earnings*"—that is, *subsequent to February 29, 1916.* These are listed year by year from that date to April 14, 1923, and then totalled. This figure ($2,430,658.30) he calls, "Total earnings March 1, 1916, to April 14, 1923", which is exactly what it is. Thus, the "total earnings March 1, 1916, to April 14, 1923" are to him the "earnings and profits accumulated *since February 28, 1913.*" He has thus wholly ignored in his result the entire time from March 1, 1913, to March 1, 1916, which, however, is a portion of the period "since February 28, 1913" fixed by the statute.

This he justifies upon the ground that the net losses of the time from March 1, 1913, to March 1,

1916, must be charged against March 1, 1913, surplus and that such surplus is thereby to that extent forever dissipated. We submit that he has not interpreted Section 201 (a), but has merely adopted a method of bookkeeping and made the statute conform thereto. Had any year between March 1, 1916 and April 14, 1923, shown a loss, he would have deducted that from the aggregate of profits in the other years between those dates; but he wholly excludes the losses of the two years from March 1, 1914, to March 1, 1916,—solely because of the accident that they came before a surplus had been built up from operations after February 28, 1913.

The answer to the bookkeeping question which the Commissioner faced is very simple. His mode of bookkeeping, if it could be substituted for an interpretation of the simple language of Section 201 (a), is itself incorrect. The statute creates two periods of accumulation and hence contemplates two surplus accounts, one for each of the two accumulation periods. The surplus of the second period, if any, is taxable on distribution. The surplus of the first period is not so taxed. On April 14, 1923, a surplus account for the second period would show $760,435.93, and not $1,160,658.30, as claimed by the Commissioner. It is not important that initially it would show a loss. We are concerned here only with how it stood on April 14, 1923.

A careful study of the act and of the nature of the tax on dividends demonstrates that Congress intended to create one entire period for determining accumulations after February 28, 1913, and not a succession of yearly periods. There is nothing whatever in the language of Section 201 (a) expressly referring to any yearly rest. The tax is laid on distri-

butions out of earnings or profits accumulated "since February 28, 1913," and these words do not naturally imply successive yearly periods, but do imply *one* period only, whether it be longer or shorter than, or equal to, a year.

The tax upon a dividend distribution to the stockholder is very different from the annual income tax upon the corporation which declares the dividend. The latter tax is upon the corporate income accumulated during the year preceding its return. The former, while taxed to the stockholder in the year in which he receives it, is often paid from earnings of prior years. This is particularly so of the liquidating type of dividend here involved. This tax looks behind the recipient to the source of the dividend to ascertain its taxability upon distribution. There is nothing about that source that rests upon the year as such. A dividend is a distribution from a storehouse filled through the aggregate operations antecedent to the date of the dividend, which rarely coincide with those of a mere year. The 1917 Act did not tax the recipient at the rates payable in the year the dividend was received, but at the rates prescribed for the years in which the profits had been accumulated (Act of 1917, Sec. 31, b). The tax here involved is not a normal tax, but a surtax. In short, the tax imposed upon dividends involves many considerations not found in the ordinary tax upon other types of income. The year has slight relation to the theory of taxing corporate distributions of income. Thus, there is nothing in the fact that income tax returns are made annually or that some taxes are based on annual earnings, that creates any inference whatever that the year was in the mind of Congress as a unit of computation in the very different situation here

presented. Instead, Congress here created a second period, as such, for the computation of accumulations "since February 28, 1913," and in consequence every year's operations—indeed every single operation of every year of that period—must be included in the computation. The Commissioner's method offends this principle in that no transaction of West Side Lumber Company from March 1, 1913, to March 1, 1916, is in any way reflected in the Commissioner's result. To the contrary, every item, whether of profit or loss, for the entire time "since February 28, 1913" should and does enter into the computation asserted by the taxpayer. Where the period for measuring taxable profits is a year, every transaction of profit and loss of that year enters into the amount "accumulated" therein. Where the period for basing the tax *exceeds* a year, likewise every transaction of profit or loss in the longer period must enter into the amount "accumulated" therein. There is no other way to compute accumulations over a period.

The word "accumulated" is used several times in Section 201. In sub-paragraph (b), the two periods before and after March 1, 1913, are brought into sharp contrast. It contains these words:

> "any earnings or profits *accumulated* or increase in value of property accrued *prior to March 1, 1913,* may be distributed exempt from the tax, after the earnings and profits *accumulated since February 28, 1913,* have been distributed."

The word "accumulated" is here twice used in the same sentence, once with reference to the *ante*-March 1, 1913, period and once with reference to the period "since February 28, 1913." In the first instance, it necessarily means the net of profits over losses in the

period from corporate organization to March 1, 1913. Can Congress be deemed to have used it in a different sense later in the same sentence with reference to the time "since February 28, 1913"? Ordinary rules of construction require it to be given the same meaning in both cases. Such rules also require that the same word in paragraph (a) of Section 201, used as it is with respect to the same subject matter, be given the same sense that it has in the above mentioned paragraph (b) of the same section. Hence, in paragraph (a) defining a taxable dividend, the words "earnings and profits accumulated since February 28, 1913" must mean the net of profit over losses from February 28, 1913, to April 14, 1923. In its ordinary sense, a sum "accumulated" in a given period is the difference between the income and the outgo of that period.* If it be established that Congress intended to create two periods, as such, by Section 201, no other meaning can be given to the word "accumulated."

The Commissioner's mode of computation not alone gives different meanings to the word "accumulated" as between paragraphs (a) and (b) of Section 201 and as between its first and second usage in the passage quoted from paragraph (b), but also as between different fact situations. If a company has had profitable years next following March 1, 1913, followed by loss years of lesser amount, the Commissioner would accept the net of operations for all these years as the "profits accumulated since February 28, 1913." If, on the contrary, the loss years came first, the net of operations only of the succeeding years

* In *Eisner* v. *Macomber*, 252 U. S. 189; 64 L. Ed. 521; 40 S. Ct. 189, the Court remarked (p. 212) that a stock dividend evidences an antecedent "accumulation of profits." This is obviously a net after deducting losses.

would be, according to his theory, the "profits accumulated since March 1, 1913." If the years of profit and loss are alternate, the net of operations for all the years is used by him, unless the first year was one of loss, in which event it is excluded.

So interpreted, a corporation with a loss of $5,000,000 in the first five years, followed by profits of $5,000,000 in the next five years, would be deemed to have "accumulated" $5,000,000 "since February 28, 1913," although its financial position at the end of the ten years is identical with its position at their beginning; whereas if the profit years had come first, followed by the loss years, the Commissioner would say that it had "accumulated" nothing in the ten years. *This gives the word "accumulated" different meanings depending upon the mere accident of the sequence of losses and profits.*

This result, he claims, flows out of an alleged bookkeeping necessity of charging all losses before a new *post*-February 28, 1913, surplus has been established, against March 1, 1913, surplus. Thus, a mere bookkeeping concept (and an erroneous one at that) is made the basis for saying that in one situation the word "accumulated," in Section 201, means the net profits for the whole series of years and in the other the net profits for only certain of those years,—in this instance seven and a fraction out of ten and a fraction years, "since February 28, 1913." It is our conception that in interpreting the statute its meaning should first be found by ascertaining the broad intent of Congress. When that has been ascertained, mere bookkeeping considerations — even if they be valid as such—must give way to that intent. The statute must not yield to bookkeeping. Bookkeeping

must find a way (and there is here a ready way) to conform to the statute.

This Court has often looked through mere bookkeeping entries to the underlying facts, as in *Southern Pacific Co.* v. *Lowe,* (*infra*) 247 U. S. 330, and in *Gulf Oil Corporation* v. *Lewellyn,* (*infra*) 248 U. S. 71 and in *Old Colony Railroad Company* v. *Commissioner,* 284 U. S. 552; 76 L. Ed. 484; 52 S. Ct. 211; and has frankly said that it is not bound by mere bookkeeping.

The Circuit Court of Appeals for the Ninth Circuit fell into the same error of interpreting the statute by a resort to bookkeeping. It said flatly with respect to the argument above presented:

> "The argument ignores both bookkeeping and reality."

It conceived that an operating loss after February 28, 1913, and before the building up of a surplus for the period following that date, had to be charged against the surplus of March 1, 1913, *as a matter of bookkeeping,* and that this consideration colored the language of Section 201 (a). This, we submit, is an erroneous approach to the question. Bookkeeping must be conformed to the intent of Congress, when that has been ascertained, and can be of no assistance in finding that intent. The method employed by the Commissioner merely presupposes a given interpretation of the statute.

2.

THE SURPLUS OF MARCH 1, 1913, HAVING BEEN ACCUMULATED BEFORE THAT DATE, IS NOT SUBJECT TO DIMINUTION BY SUBSEQUENT OPERATIONS AND, BEING TAX-FREE, IS TREATED BY THE REVENUE ACT OF 1921 (AND FORMER ACTS, BEGINNING WITH THE ACT OF 1916) PRECISELY AS IF IT WERE CAPITAL.

The argument of the Commissioner and of the court below reverses the proper direction of approach, which is first to ascertain the plan of the tax, the intent and reasons which lie behind it and the rational meaning of the language employed. For this, the Commissioner and the court below substitute argumentation as to how books are kept and about hazarding the surplus in the business, "restoring" the surplus, carrying profits backward or losses forward, and exemptions. The very simple thing before the Court instead is: when Congress levied a tax on the recipient of the corporate "earnings and profits accumulated since February 28, 1913," did it mean to tax a sum *greater* than the whole net profits of the Company after February 28, 1913? If it did not, but fixed that net as the maximum (as it seems clearly to have done, not alone by paragraph (a), but also by the words in paragraph (b) "to the extent of such earnings and profits accumulated since February 28, 1913") considerations of hazarding capital, replacing capital, carrying forward losses, carrying profits backward, absorbing profits—all mere accountancy conceptions—are purely extraneous matters. Just why under any rational tax plan *should* losses sustained by a company be ignored merely because they came first? The reason given is

wholly artificial. Why *should* Congress be deemed to have intended on distributions after February 28, 1913, to have taxed to the stockholder *more than the company itself made* after that time? The person claiming such an irrational intent should be required to demonstrate it from some express or unmistakably clear requirement of the language of the act itself and not by resort to the language of the bookkeeper. The rational conception is the simple one, namely, that Congress meant to reach, in the hands of the stockholder, *all* the net profits the corporation made and distributed after the enactment of the Sixteenth Amendment—*and no more,* and that it required the taxable surplus to be distributed before the non-taxable surplus of March 1, 1913.

The court below also said:

> "If, however, instead of distributing the surplus, the corporation, as in this case, subjects it to the hazards of the business, there is no provision for restoring, out of future normally taxable earnings, any part of the surplus that may thereby have been lost."

There is no need for any such provision. The surplus of March 1, 1913, is "restored" automatically by the very terms of the act. Indeed, we submit, that is its plain purpose. By the act there is nothing to tax until the second period (beginning March 1, 1913), as a period of accumulation, shows a surplus of its own. It can show no surplus as a period until its later earnings have not alone equalled the prior losses, but have exceeded them. The incidence of the tax is placed only upon such *excess, i. e.,* the "earnings and profits accumulated since February 28, 1913." By the time there is the first dollar of such

an excess, the surplus of March 1, 1913, has automatically been "restored."

This conclusion, of course, assumes that Congress has created two entire periods for measuring accumulations. If this fundamental conception of the intent of Congress has been established, the automatic "restoration" of March 1, 1913, surplus is found to be an integral part of the plan of the tax. Hence, it is evident that the real inquiry in this case is whether Congress intended to create an entire period "since February 28, 1913" for measuring taxable accumulations, and what it meant by the words "accumulated since February 28, 1913." We are not aided in that interpretation by a search for language expressly authorizing a restoration of the surplus of the *first* period, for the words under interpretation concern only the surplus of the *second* period.

The Commissioner's conception of a surplus is that of a pile of ear-marked dollars. The court below seems to have had the same conception. If then a dollar is taken from the pile, even temporarily, that dollar cannot be replaced. This is a wrong conception of a surplus, which may, and usually does, exist not so much in cash or bank credits, as in fixed assets, real estate, timber, accounts receivable, patents, good will or what not. Indeed, a balance sheet of a corporation at the end of its fiscal year may show a diminution of surplus as the result of the year's operations, yet it may actually have on hand more cash, bank credit and tangible assets than at the beginning of the year. This often happens through the mere changes in dollar value of inventories and other tangible assets. These conceptions have no place in interpreting a statute. The obviously correct ap-

proach is to find what plan of taxation was intended. All else must yield to that intent.

The Commissioner and the lower court consider March 1, 1913, surplus forever dissipated by losses immediately following that date, much as though Section 201 (b) had read:

> "But any of the earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, *and not lost in carrying on the business of the corporation between March 1, 1913, and the date of this Act,* may be distributed" * * * etc.

But the Acts of 1916 and 1921 do not read that way. They recognized March 1, 1913, surplus, as such, a fixed amount—and not as diminished or increased by subsequent occurrences. And the same language has been employed in every act since. The 1924, 1926, 1928 and 1932 Acts all provide, without any limitation whatever, that the earnings prior to March 1, 1913, may be distributed tax-free. Yet in this case the Commissioner is claiming, not that the surplus of March 1, *1913,* but the surplus of March 1, *1916,* is to be distributed tax-free.

It is conceded by the Commissioner that paid-in capital may be "restored" out of *post*-February 28, 1913, earnings, but there is no express provision in the act to that effect. It follows of necessity from the fact that it is capital. But Congress, by this provision taxing *only* the accumulations *since* February 1, 1913, has put March 1, 1913, surplus on precisely the same footing as paid-in capital, for the purposes of the act. By taxing only what was "accumulated" from operations through a given *post*-February 28, 1913, period, it has excluded from tax on distribution an amount equal to the surplus existing when the

second period began, and so for this purpose has given the prior surplus the attributes of capital. The Circuit Court of Appeals for the Seventh Circuit rightly so held in the *Canfield* case. This interpretation makes the act wholly consistent throughout, *i. e.*, if the surplus be treated as capital for the purposes of the act, the net after February 28, 1913, is automatically left to tax. Or, conversely, if the word "accumulated" means the net and that alone is taxed, the surplus of March 1, 1913, is automatically left untouched and untaxed.

This Court has repeatedly used language to the effect that March 1, 1913, surplus must be treated like capital. In *Southern Pacific Co.* v. *Lowe* (247 U. S. 330; 62 L. Ed. 1142; 38 S. Ct. 540) it said:

> "This being so, we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the Act."

Similar statements occur also in *Gulf Oil Corporation* v. *Lewellyn* (248 U. S. 71; 63 L. Ed. 133; 39 S. Ct. 35); *Eisner* v. *Macomber* (252 U. S. 189; 64 L. Ed. 521; 40 S. Ct. 189); *Lucas* v. *Alexander* (279 U. S. 573; 73 L. Ed. 851; 49 S. Ct. 426), and *Old Colony Railroad* v. *Commissioner* (284 U. S. 552; 76 L. Ed. 484; 52 S. Ct. 211). Congress here has therefore made static the amount distributable tax-free. The Commissioner will concede that it may never be increased beyond the amount of the surplus of March 1, 1913. It is a constant, not a variable. This follows from the fact that Congress did not tax it, but taxed only something else,—the excess of profits over losses for the period after February 28, 1913. This is but another way of saying that it made the surplus of March 1, 1913, like capital for the pur-

poses of the act. These forms of expressing the same idea are all convertible. Congress itself has expressed this view of March 1, 1913, surplus. In House Report 179 (First Session of the 68th Congress) of the Ways and Means Committee, the following passage appears:

> "The theory which causes the allowance of the receipt of the dividend free of tax is that this distribution, being out of earnings accumulated prior to March 1, 1913, constitutes a return of capital to the stockholder. If it is treated as a return of capital for purposes of taxation, it should manifestly be considered a return of capital for purposes of determining his capital investment in the stock and the resulting gain or loss from its subsequent sale."

Congress has squarely recognized March 1, 1913, surplus as capital for the purposes of the income tax, by the last sentence of paragraph (b) itself. This reads:

> "If any such tax-free distribution has been made, the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in Section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon."

Under this provision, a taxpayer buying stock for, say, $400 per share, receiving a tax-free distribution of $50 per share (in addition to ordinary dividends) and then selling for $300 per share, would have had a deductible loss of $50 per share and not $100. In short, the tax-free distribution was treated by the act as a mere return of capital. There was no dif-

ference, in computing his deductible loss, between it and his original capital investment. A similar provision is found in every act since the 1921 Act,—in the following words, beginning with the 1924 Act:

> "But any such tax-free distribution shall be applied against and reduce the basis of the stock provided in Section 204" (Sec. 113 in the 1928 Act).

The 1921 Act covered only losses. The 1924 and later acts applied the same rule also in measuring profits.

The court below seemed to feel that *Lynch* v. *Hornby* (247 U. S. 339; 62 L. Ed. 1149; 38 S. Ct. 543) is inconsistent with our view that the Act of 1921 made March 1, 1913, surplus as if it were capital for the purposes of the act. It is not inconsistent. *Lynch* v. *Hornby* was decided under the 1913 Act, and Section 2 (a) of the 1916 Act (defining a taxable dividend in substantially the language of the 1921 Act) was passed to change the rule of *Lynch* v. *Hornby*. With that provision, March 1, 1913, surplus became untaxed on distribution. The tax henceforth was to be laid, not on dividends as such, but only upon one specific variety of dividend,—namely, one from earnings made *after* March 1, 1913. Thus, March 1, 1913, surplus was put in exactly the same position as though it were capital, for both it and paid-in capital, or paid-in surplus, could be distributed tax-free. That provision was repeated, in the 1921 Act, and, hence, we insist, the March 1, 1913, surplus was under it to be treated precisely as capital for the purposes of the act.

The Commissioner has not at all times relied upon his bookkeeping concept of the statute and upon the theory that March 1, 1913, surplus is permanently dissipated by losses occurring in the first years following February 28, 1913, but up to and through the Board of Tax Appeals chiefly urged what he has termed his "retrogressive" method of arriving at accumulations "since February 28, 1913." This he bases upon certain words occurring in paragraph (b) of Section 201.

The pertinent part of that paragraph reads:

> (b) "For the purposes of this Act, every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed."

The Commissioner isolates the first twenty-four words of this paragraph and, in particular, the words "most recently accumulated," and from them concludes that the proper mode of arriving at the accumulations of the taxable period as against the accumulations of the non-taxable period, is to begin with the last year of the operations of the taxable period and then to add to its earnings those of the next prior year, and so on up the column until the loss years are encountered, whereupon he stops. This eliminates the loss years from the reckoning. His tabulations in this case (Trans., 43-45) do not follow this method in form, but as the result there reached happens to coincide with the result that would occur if he applied the "retrogressive" method of compu-

tation (inasmuch as there were no loss years alternating with profit years) he has sought to justify the tabulation in the transcript by these isolated words of paragraph (b).

These words have no such effect. They have reference only to differences in the taxing of distributions as between the several years of the *post*-February 28, 1913, period as to which the policies of Congress have from time to time varied. They have nothing to do with the mode of arriving at the taxable and non-taxable portions of a dividend *as between the two periods before and after March 1, 1913,* as to which the policy of Congress has never changed. This is readily demonstrated by the legislative history of paragraph (b). It shows that the "retrogressive" theory of the Commissioner in computing the taxable portion of a dividend declared in part from March 1, 1913, surplus is without foundation. The taxable portion is to be computed by including all years of the period instead of working upwards and backward to and stopping with loss years.

3.

THE OPINION OF THE CIRCUIT COURT OF APPEALS.

The Court below in support of its conclusion, asserts that the officials of the Treasury Department have for years interpreted Section 201 as the Commissioner here construes it. The first ruling of the Treasury Department was in 1920 (A. R. M. 82; 3 Cumulative Bulletin 36). We are construing the 1921 Act. It can hardly be conceived that failure of Congress to insert a provision in the 1921 Act specifically negativing that obscure ruling can be deemed

an approval of it. No showing has been made that Congress knew of it then—or indeed even in 1932. Actual cases in the Board of Tax Appeals or the Courts have only just begun. *Hadden* v. *Commissioner* (49 Fed. (2d) 709; C. C. A. 2, 1931) was the first case presenting the issue—and the Commissioner and the Court below insist that even it does not do so. Thus the first cases on the issue, which the Commissioner will concede have ever reached the Board of Tax Appeals or the courts, are these present *Canfield* and *Thorsen* cases, and the first case upon that issue ever to be decided by any court—the *Canfield* case—was there determined adversely to the Commissioner's interpretation.

Even though Congress were shown to have known of the 1920 ruling (or later ones) and had then failed to amend the section in the 1921 or later acts, no inference of approval could be drawn therefrom, for Congress may well have deemed the language of Section 201 (a) to be plain and sufficient and have relied upon the courts correctly to construe it. Congress cannot be expected by legislation to anticipate or to catch up with all the errors of the Commissioner. It has definitely asserted the position we present, for in House Report 179 (*supra*, p. 28) and Senate Report 398 of the First Session of the Sixty-Eighth Congress, it expressly recognized March 1, 1913, surplus as capital for the purposes of the act. Certainly, a Government department cannot by misinterpreting a statute, even through a period of years, bind the courts to an erroneous conclusion nor require Congress to negative its construction.

Burnet v. *Chicago Portrait Company*, 285 U. S. 1; 76 L. Ed. 587; 52 S. Ct. 275.

We have pointed out the mistaken approach of the court below to the real question in this case. The problem is simply to determine what portion of the dividend Congress made subject to the tax. The answer must be found in the correct interpretation of Section 201 (a). But the court below, we respectfully submit, has centered its attention on Section 201 (b), which merely supplements and in no wise limits (a). It seems principally to have considered what part of the dividend was distributable tax-free. Then, laboring under what we must characterize as a wholly indefensible conception of the real nature of a corporate surplus, it arrived at a wrong conclusion.

In its opinion, the court below seems to have ignored the well settled rules of construction of tax laws; to have failed properly to consider that part of the statute from which alone the authority to tax that part of the dividend accumulated after February 28, 1913, is taxed; to have misconstrued the meaning of the word "accumulated" as used in the law and to have overlooked the plain intent of the law to create two distinct periods—one for accumulations to be taxed and another for accumulations to be distributed tax-free.

The court below, in effect has construed Section 201 so that it does not have uniform application in that it would make the amount of the tax depend, not on the real position of the corporation, but on the mere sequence of losses and profits. Such a construction does violence to the plain words of the law.

Putting first things first, the Circuit Court of Appeals for the 7th Circuit approached the problem in this case by considering at the outset the question of

what part of the dividend was taxable under the law and reached a solution which, we submit, is indubitably right.

Its solution is in accord with the clear and pointed dissenting opinion of the minority of the Board of Tax Appeals and, it may be noted, in accord with the view of the entire Board when it came to reconsider precisely the same question in the Walker case.

We submit that the judgment in this case should be reversed.

Respectfully submitted,

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